

Macro-Strategy Key Issue

ECB: hawkish decision, dovish guidance

Economics

Europe including UK

Despite reduction in QE, ECB commits to maintaining substantial stimulus

The ECB announced that it will scale back its monthly asset purchases from currently €80bn to €60bn as of April 2017 until December 2017. At first sight, this would have seemed to be a hawkish move, but ECB President Draghi managed to package this decision with dovish commentary, by stressing that the ECB stands ready to increase/extend QE if needed and that tapering was not discussed and is "not in sight".

We expect the ECB to start tapering in Jan 2018, wind down QE by end-2018

We now expect the ECB to conduct monthly asset purchase of €60bn per month from April to December 2017 – in line with the ECB's guidance. As of January 2018, however, we expect the ECB to start tapering and wind down its asset purchases over 12 months, i.e. until December 2018. Although Mr Draghi said that tapering was not discussed today, we think that gradually rising inflation and increasing discomfort about the long-term distortions of QE will lead a rising number of ECB Governing Council members to support a gradual exit from QE over the course of 2018.

New ECB macro projections: bullish on growth, cautious on inflation

The ECB's new macro forecasts for 2017-19 convey a constructive outlook for growth, but ongoing caution regarding inflation. The growth forecast was raised to 1.7% (from 1.6%) for 2017, but left unchanged at 1.6% for 2018; the newly-introduced forecast for 2019 is also 1.6%. (We are more cautious on growth, projecting 1.3/1.2% for 2017/18.) The ECB raised its inflation projection slightly to 1.3% for 2017, but surprisingly lowered it to 1.5% from 1.6% for 2018. For 2019, the ECB now projects 1.7%, which according to Mr Draghi would still not be in line with the ECB target.

FX: We still see limited scope for further EUR downside

Today's policy decisions by the ECB have not changed the direction of monetary policy fundamentally. As a result, we don't think that it will trigger renewed momentum for policy divergence and expect the EUR to remain supported from here.

Rates strategy: Draghi squares the circle for now

Mr Draghi managed to square the circle by reducing monthly QE purchases while emphasising it is not the start of tapering QE. From this perspective he reduced the negative market impact for risk sentiment, while soothing the hawks on the GC. Lower monthly Bund purchases in conjunction with the technical changes to the APP saw the Bund curve steepen from both ends. We do not expect the changes to the PSPP securities lending to be a game changer. We stick to our strategic curve steepening recommendation in 5s30s Bunds and 10s30s 4y fwd EUR IRS, long 30y Gilts vs Bunds as well as 2yr vs 5yr German ASW boxes. We adjust the stop on our receiving 2y1y Eonia forwards recommendation and remain cautious on EGB spreads vs Bunds.

Corporate credit

Given the reduced program, we expect corporate bond purchases by the ECB to slow to an average of €6bn per month from the current €8bn per month. Currently, spreads for both IG and HY corporate credit are broadly unchanged since before the announcement. With strong demand for corporate paper, we expect widening in the longer duration bonds while the front end should still remain supported. Going forward, we anticipate EUR IG issuance to slow from its initial flurry, but to remain sizeable given the ECB's presence in the market for all of 2017.

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Hawkish decision, dovish commentary

The ECB announced that it will scale back its monthly asset purchases from currently €80bn to €60bn as of April 2017 until December 2017. At first sight, this would have seemed to be a hawkish decision, but ECB President Draghi managed to "package" this decision with dovish commentary:

- The ECB committed to €60bn of asset purchases over the course of nine months, not just six.
- The ECB explicitly left the door open for a return to higher monthly amounts and/or an extension of QE beyond December 2017 if the outlook were to worsen again and/or inflation were still not on track to sustainably return to the ECB's target.
- Mr Draghi said that "tapering" – defined as a gradual reduction in monthly asset purchases towards zero – had not been discussed; he even argued that tapering was "not in sight".
- Mr Draghi stressed that the ECB was committed to maintain an "extraordinary degree of monetary stimulus" and that the Bank will "sustain its presence" in the markets.
- The ECB's new staff macroeconomic forecasts, with a 2019 inflation forecast of just 1.7%, arguably leave the door open for extended stimulus.

"Broad-based consensus" towards reduction to €60bn

Reportedly, the ECB Governing Council discussed two policy options: a six-month extension of monthly asset purchases of €80bn – which was our call – and a nine-month extension of €60bn. According to Mr Draghi, there was "very broad-based consensus" towards the second option. The ECB President explained that the increase of monthly asset purchases from €60bn to €80bn in March 2016 came against the background of a challenging environment at the time, but that things had stabilised in a way that allowed the ECB to reduce the volume of QE again. He mentioned that markets had proven more resilient to recent political events than many would have anticipated.

New ECB macro forecasts: constructive on growth, cautious on inflation

The ECB's new staff macro forecasts convey a constructive outlook for growth, combined with a muted assessment of the inflation outlook. The 2017 real GDP forecast was increased to 1.7% (up from 1.6%), the projection for 2018 was left at 1.6% and the newly introduced 2019 forecast is also 1.6%. Consumption is projected to hold up well even as oil prices are now drifting higher, partly reflecting the assumption that household savings rates will decline and wages increase. We are more cautious on the growth outlook for domestic demand and growth overall (forecasting GDP growth of 1.3% and 1.2% in 2017 and 2018).

On inflation, the 2017 forecast was raised to 1.3% from 1.2%, but the 2018 forecast was lowered to 1.5% from 1.6% (reflecting a more subdued outlook for core inflation, which was lowered by 0.1pp relative to September, to 1.4%). For 2019, inflation is forecast to be 1.7% and Draghi responded to a question in the press conference that this was not in line with the ECB's definition of price stability.

Figure 1: Eurosystem staff macroeconomic projections for the Euro area, annual % change

	December 2016				September 2016		
	2016	2017	2018	2019	2016	2017	2018
Real GDP	1.7	1.7	1.6	1.6	1.7	1.6	1.6
	[1.6 – 1.8]	[1.1 – 2.3]	[0.6 – 2.6]	[0.4 – 2.8]	[1.5 – 1.9]	[0.7 – 2.5]	[0.4 – 2.8]
HICP	0.2	1.3	1.5	1.7	0.2	1.2	1.6
	[0.2 – 0.2]	[0.8 – 1.8]	[0.7 -2.3]	[0.9 – 2.5]	[0.1 – 0.3]	[0.6 – 1.8]	[0.8 – 2.4]
HICP ex energy	0.9	1.1	1.4	1.7	0.9	1.2	1.5
HICP ex food and energy	0.9	1.1	1.4	1.7	0.9	1.3	1.5
HICP ex food, energy & indirect taxes	0.8	1.1	1.4	1.7	0.9	1.2	1.5

Source: ECB 'December 2016 ECB staff macroeconomic projections for the Euro area', 8 December 2016.
<https://www.ecb.europa.eu/pub/projections/html/index.en.html>

Our new call: €60bn until end-2017, followed by tapering in 2018

We now expect the ECB to conduct monthly asset purchases of €60bn per month from April 2017 until December 2017 – in line with the ECB's guidance. As of January 2018, however, we expect the ECB to start to taper and steadily wind down its asset purchases to zero over the course of 12 months, i.e. until December 2018. Although Mr Draghi said that tapering was not discussed today, we think that gradually rising inflation, together with increasing concern about the long-term distortions of QE, will lead to a rising number of ECB Governing Council members supporting a gradual exit from QE over the course of 2018. (So far, we expected tapering to start in October 2017 and proceed over the course of one year, until the fall of 2018.) We think that a tapering decision might come as early as on 7 September or on 14 December 2017; on these dates, the ECB will once again present staff macroeconomic projections.

In a sense, we interpret today's meeting outcome as somewhat more hawkish than displayed by Draghi. The fact that the Governing Council took an arguably-difficult-to-sell decision in an environment of political uncertainty, rising bond yields, and ahead of the Fed might be a sign of determination amongst a number of GC members not to let QE turn into a long-term solution.

No more rate cuts, but no quick rate hikes either

Our base-case scenario implies that ECB policy rates have bottomed out, with the depo rate at -0.4%, the refi rate at zero, and the marginal lending rate at 0.25%. However, the ECB reiterated today that rate *hikes* should only be expected once the QE programme has come to an end. Assuming that QE will run until the end of 2018, we think that ECB policy rates will remain at current levels well into 2019.

ECB policy rates unlikely to rise before 2019

FX: Still limited scope for further EUR downside

Today's policy decisions have not altered our views that the scope for further downside in the EUR is limited and that EUR/USD in particular is unlikely to drift towards parity. Despite a favourable reaction by equity markets and a sell-off in the EUR (EUR/USD sold off by 1.5%), the overall direction of monetary policy remains fundamentally unchanged by the ECB. On the other hand, a lot is in the price both as regards the prospect for US reflation and political risk premia in the Eurozone. In addition, the EUR remains undervalued by any measure (e.g. PPP, current account).

As a result, we don't think that today's meeting will trigger renewed momentum for policy divergence and expect the EUR to remain supported from here.

Rates Strategy: The ECB reduces monthly purchases, but does not taper

Contrary to our base line expectations, the GC reduced monthly APP purchases from €80bn to €60bn as of April next year, while extending the QE programme until December 2017. In today's market reaction the broader risk sentiment remained fairly stable, while the GC's monetary policy decisions had a big impact on the core EGB curves, first and foremost for Bunds. Lower monthly Bund purchases in conjunction with the technical changes to the APP (widening the eligibility pool to 1yr to 31yr and removing the deposit rate floor for QE purchases) the Bund curve steepened from both ends.

We highlighted in our [ECB Preview](#) that a reduction in the monthly purchases could be seen as the start of tapering with markets extrapolating monetary policy tightening which would have an adverse impact on risk sentiment (i.e. widening of EGB spreads against Bunds). However, despite initial volatility in EGB vs. Bund spreads the wider risk sentiment was actually unscathed by today's GC decision.

The risk of a negative read by the market was countered by the ECB's pronounced dovishness on the forward guidance. The key points are that:

- First, in the monetary policy decision the original forward guidance was retained linking QE to a sustained adjustment of the inflation path towards the ECB's target (i.e. the implicit open-endedness of QE). In particular the relatively low 2019 inflation forecast should be seen as a dovish signal.
- Second, in case of a deterioration of the inflation outlook the Governing Council intends to increase the programme in terms of size and/or duration.
- Third, and probably most important, Mr Draghi drove home the message that the reduction of the monthly QE purchases is not the start of tapering. Draghi underlined that the ECB's definition of tapering is a policy whereby purchases would gradually go to zero which has not been discussed in today's meeting.

Basically, Mr Draghi managed to square the circle by reducing monthly QE purchases while emphasising it is not the start of tapering QE. From this perspective he reduced the negative market impact for risk sentiment, while soothing the hawks on the GC.

Technical APP changes increase the Bund eligibility pool substantially

The steepening of the Bund curve (from both ends) was driven by lower monthly amounts of QE and therefore Bund purchases as well as the technical changes to the QE parameters. To begin with, buying less Bunds increases the Bundesbank's flexibility of circumventing the scarce ultra-long end of the Bund curve during the course of QE purchases. In our estimates and at current market pricing this would equate to a reduction of monthly Bund purchases from €9.5bn to €7bn.

Broader risk sentiment remained fairly stable, while the GC's monetary policy decisions had a big impact on the core EGB curves

Mr Draghi managed to square the circle by reducing monthly QE purchases while emphasising it is not the start of tapering QE

Lower monthly purchases as well as technical changes to the APP drove Bund curve steepening from both ends

The extension of the initial 2yr-31yr target maturity range to 1yr-31yr (which we did not expect) and the removal of the deposit rate floor for QE purchases (starting next year) added €262bn of nominal German sovereign paper to the QE eligibility pool (Figure 2). On aggregate, the new technical QE framework allows Bund purchases to be made through Q1 2018 in our estimates.

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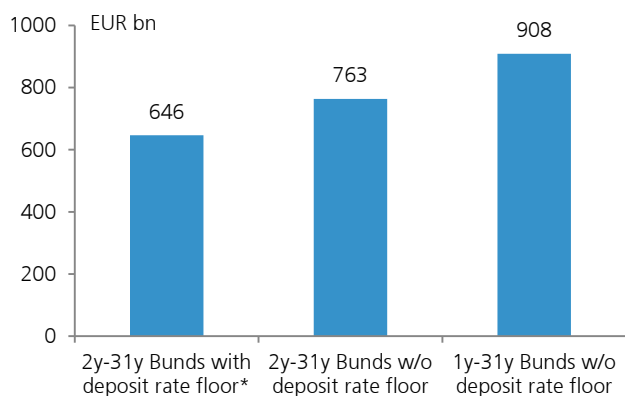
Recall, the ECB still has the flexibility to increase ISIN and issuer limits going forward to extend the implementation period for QE even further. We would have expected changes on that front already at the December meeting. However, allowing purchases in the 1y-2yr segment actually has a bigger impact on the Bund eligibility pool than increasing the ISIN limit on non-CAC Bunds from 33% to 50%.

The fact that ISIN/issuer limits were not adjusted weighed on PGBs

The fact that the GC refrained from making any changes in the 33% ISIN/issuer limits holds more importance beyond the Bund market. These limits currently constrain purchases of Portuguese and Irish bonds in EGB space, owing to legacy SMP holdings of those countries' bonds by the Eurosystem. Inaction on the ISIN/issuer limit front, however, has mainly affected PGBs as the weaker credit of the two, which are trading 20bps wider in 10y.

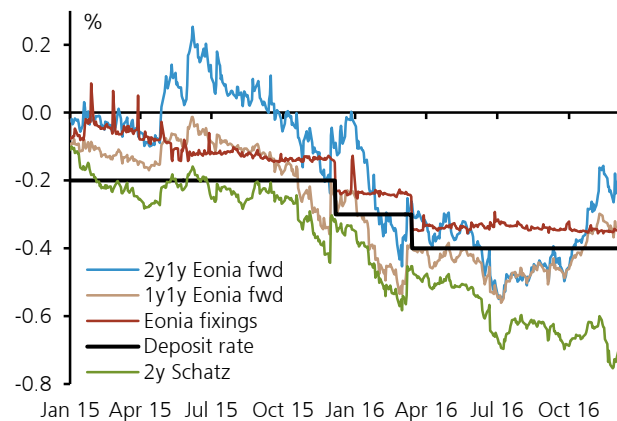
We have argued before that [PSPP purchases is the main support factor for PGBs](#) against a background of weak macro fundamentals and a weak ratings profile. The unwillingness of the GC to lend an additional helping hand today highlights the lack of directionality for PGBs absent fundamental improvements. Thus, we continue to see [far better risk-reward in Cyprus EMTNs](#) due to better fundamentals and a positive ratings trajectory.

Figure 2: Nominal QE eligibility pool for Bunds increased substantially



Source: UBS, Bloomberg. *at current market pricing

Figure 3: Schatz yields decoupled from the deposit rate, but Eonia forwards are still too high



Source: UBS, Bloomberg

Changes to the securities lending facility unlikely to be a game changer

We mentioned in our [ECB Preview](#) that the ECB should not venture into sub 2yr maturities due to concerns about the decoupling of the front-end of the Bund curve from ECB policy rates (Figure 3). After some retracement over the past days, the Schatz was well bid on the back of the technical APP changes. The changes to the PSPP securities lending facilities could stop the slide in Schatz yields, but it is unlikely to be a game changer for that or turn around ASW spreads substantially.

The GC [announced](#) that Eurosystem central banks will now have the possibility to accept cash as collateral for the PSPP securities lending facilities. Recall, the Eurosystem makes bonds available in reverse repos, but so far only 'cash neutrality', i.e. in a bond collateral exchange of similar credit quality. Now the Eurosystem accepts cash as collateral up to a maximum overall limit of €50bn.

However, in the context of the overall size of the securities held in the programme we do not see this as a game changer especially at its current pricing. The cash collateral option will be offered at a rate equal to the lower of the deposit rate minus 30bp (currently -70bp) and the prevailing market repo rate. Other things being equal, the announcement of these measures would be supportive for somewhat cheaper ASWs in Germany only to the extent that the €50bn overall limit is used for German bonds and repo levels would stop falling.

A more meaningful way to tackle the collateral shortage in German bonds would be if the Bundesbank's decided at a later stage that the non-German bonds would be accepted as collateral for repo operations. However, this would undermine the capital key allocation through the backdoor besides being far beyond the risk appetite of most core NCBs and thus rather unlikely to materialise anytime soon.

How to position going forward?

Despite the fact that our base line expectations did not meet the ECB's monetary policy decision, we do not see a substantial need to adjust our recommended positioning at this stage.

While we would not have anticipated today's curve moves, our strategic focus remains on steeper curves and gradually higher Bund yields as we outlined in our [2017 Market Outlook](#). Our preferred expressions remain 5s30s Bund steepeners as well as 10s30s EUR IRS 4y forward. We think forwards are still too low (i.e. there is still a decent carry and roll). Moreover, the 5-year point on the curve looks well anchored given growth and inflation dynamics, while 10 and 30-year rates are more susceptible to the risk of a US-driven yield increase. We expect the ECB QE programme to shift purchases into shorter maturities over the next few months, driven by changes to the modalities of the QE program. The ultra-longs remains the weakest link on the Bund curve going forward (i.e. the ultra-long curves flattening less in a rally, but steepening more in a sell-off).

On a cross-market basis, we continue to see scope for further underperformance in long-end Germany vs UK gilts. This position benefits from our expectation of a further rise in German yields and the prospect of [further easing by the BoE](#) (in the form of additional QE and a small rate cut) in the middle of 2017. Our preferred way to position for this is to [buy 30yr gilts vs Bunds](#).

Moreover, the ECB's dovish forward guidance should make market pricing of a full deposit rate hike from the ECB by end 2018 less likely (as the decrease in the monthly QE purchases is not the start of tapering). We stick to our view that Eonia forwards should be lower. While the price action pushed our 2y1y Eonia forward recommendation above its stop level, we adjust the stop to -14bp and stick to our target at -34bp.

We still consider the pricing of 2y German ASW as too rich relative on the ASW curve and stick to our recommended 2yr vs. 5yr ASW boxes. Our argument that Bundesbank purchases should not too drastically be focused on the very front-end should be supported by Mr Draghi's emphasis that purchases below the deposit rate are an option, but not a necessity at the moment.

PSPP securities lending unlikely to be a game changer, despite accepting cash collateral

We stick to strategic curve steepeners expressed via 5s30s Bunds and 4y fwd 10s30s EUR IRS

Cross markets we hold on to long 30y Gilts vs Bunds

We extend the stop on our receiving 2y1y Eonia fwds

We continue to see value in 2yr vs. 5yr German ASW boxes where the Schatz is too rich

Lastly, we remain cautious with respect to the risk sentiment in EGB spreads and recommend a neutral stance against Bunds. QE purchases were not titled in favour of peripheral EGBs and also BTPs&Co will see lower purchases going forward. We expect that, post ECB, political developments will likely continue to drive spreads.

We remain cautious on EGB spread positions

Corporate credit

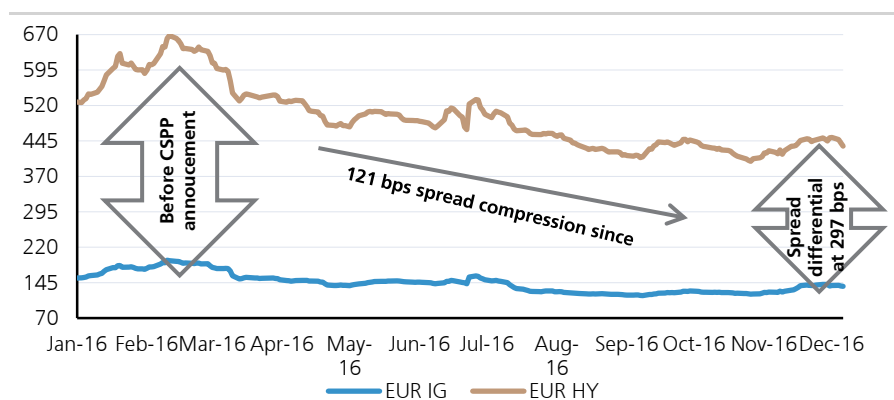
Given the overall reduced program, we expect corporate bond purchases by the ECB to slow to an average of €6bn/month from currently €8bn/month, with a total of ~€48bn since purchases began in June. Currently, spreads for both IG and HY corporate credit are broadly unchanged since the announcement, while underlying European government curves have steepened. With strong demand for corporate paper, we expect widening in the longer duration bonds while the front end should still remain supported. Going forward, we expect EUR IG issuance to slow from its initial flurry, but remain sizable given the ECB's presence in the market for all of 2017. Total Eur IG issuance YTD stands at €511bn, up 2% on the same period in 2015 whereas Eur HY issuance is down ~26% on the same period.

Figure 4: Eur corporate credit issuance

€ bn)	IG			HY			CSPP	CSPP Eligible issuance
	Month	YTD 2016	YTD 2015	% Chng	YTD 2016	YTD 2015	% Chng	YTD 2016
Jan	34	71	-52%	1	8	-85%	-	-
Feb	52	59	-12%	1	8	-90%	-	-
Mar	81	72	12%	6	14	-58%	-	-
Apr	65	44	49%	5	9	-47%	-	-
May	71	51	40%	6	3	131%	-	27.0
Jun	26	28	-6%	4	5	-10%	4.9	10.4
Jul	29	25	16%	3	8	-65%	8.3	14.3
Aug	20	13	58%	1	1	139%	6.1	11.1
Sep	48	58	-18%	12	3	302%	10.4	20.9
Oct	50	34	46%	4	2	99%	8.1	27.2
Nov	38	50	-24%	3	4	-6%	8.4	17.3
Dec	5	7	-26%	1	1	-9%	2.0	1.5
Total	519	511	2%	48	65	-26%	48.2	129.7

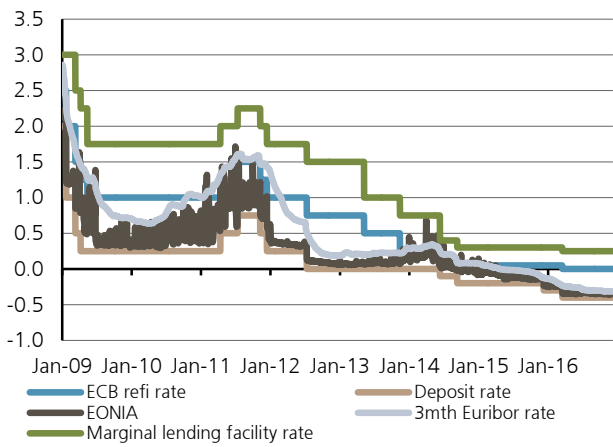
Source: Bloomberg, Dealogic, UBS.

Figure 5: YTD spread compression



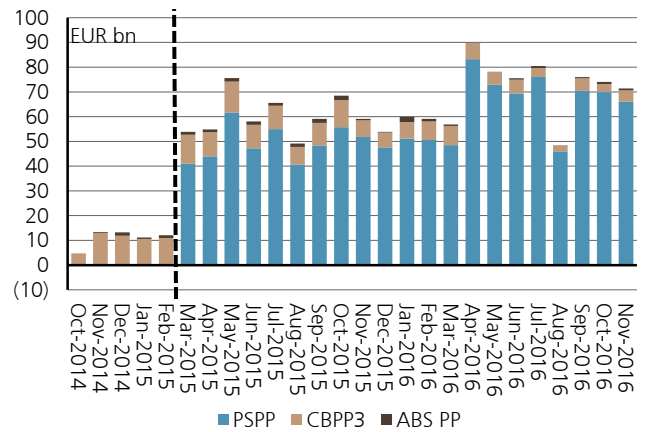
Source: Markit, UBS.

Figure 6: ECB interest rates, EONIA and Euribor (%)



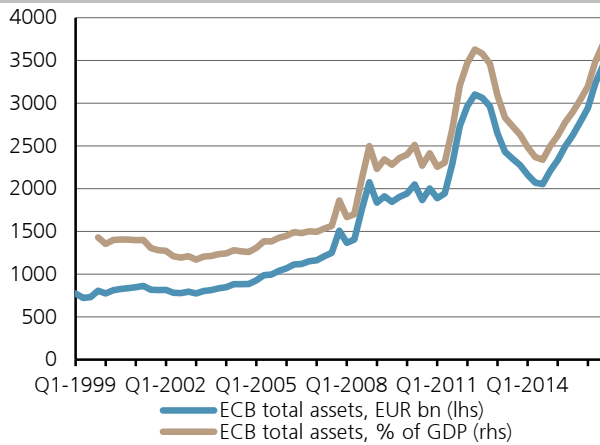
Source: Haver, UBS

Figure 7: ECB's Expanded Asset Purchase Programme



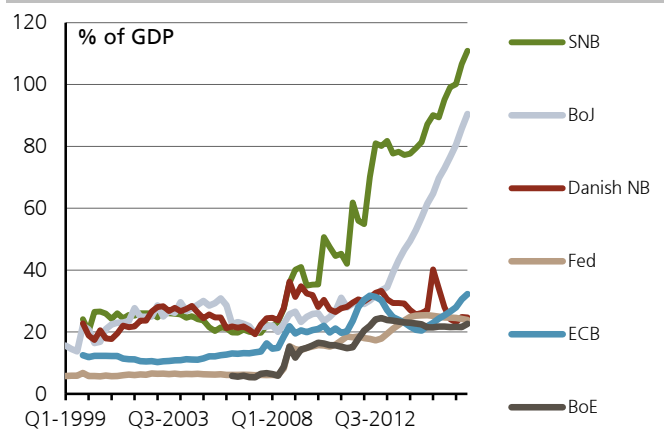
Source: ECB, Haver, UBS PSPP: Public Sector Purchase Programme, i.e., sovereigns, agencies, supranationals. ABS PP: Asset Backed Securities Purchase Programme. CBPP3: Covered Bond Purchase Programme 3.

Figure 8: ECB balance sheet



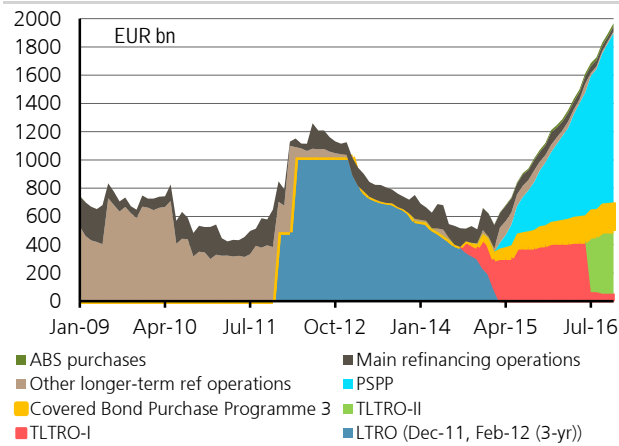
Source: ECB, Haver, UBS

Figure 9: Other central bank balance sheets, % of GDP



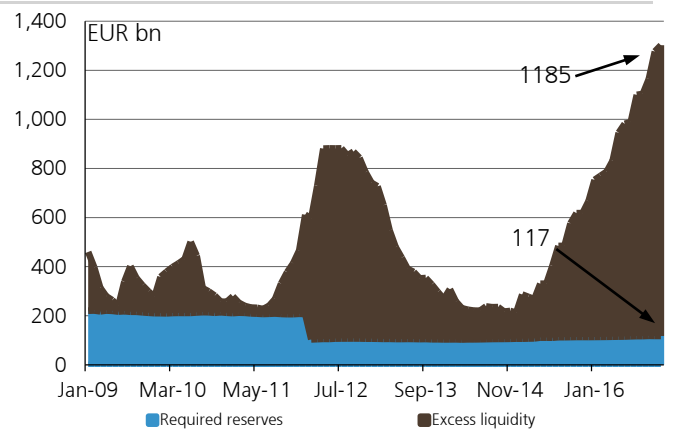
Source: Haver, UBS

Figure 10: Asset side of ECB balance sheet



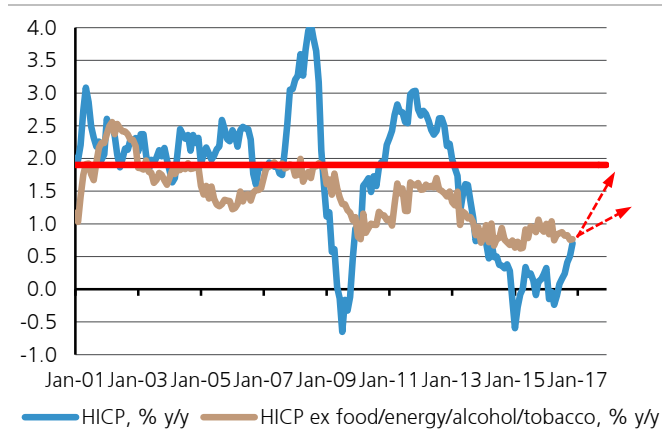
Source: Haver, UBS

Figure 11: ECB excess liquidity



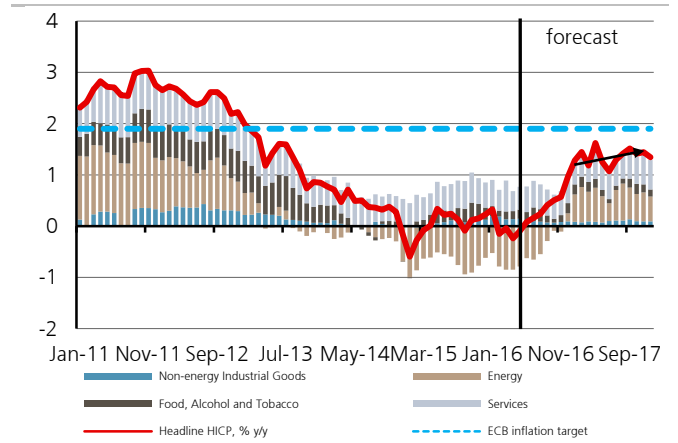
Source: Haver, UBS

Figure 12: Eurozone headline and core inflation



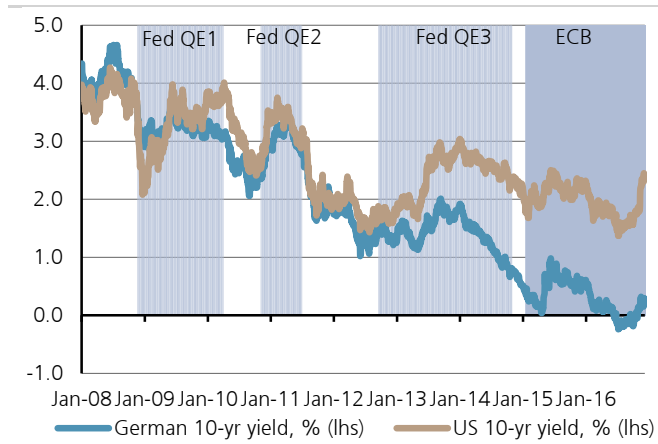
Source: Haver, UBS

Figure 13: Contributions to Eurozone HICP inflation, ppt



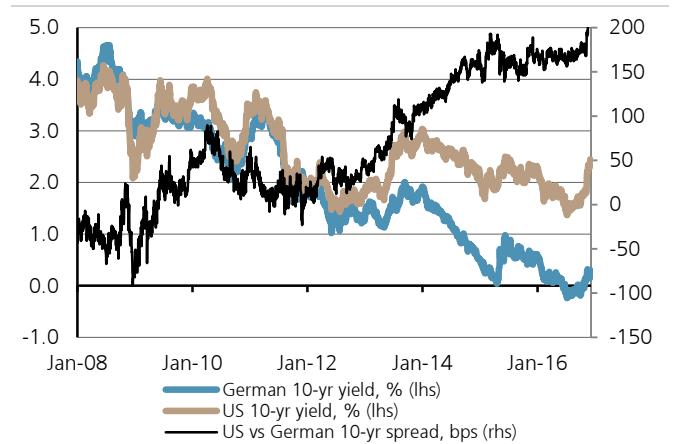
Source: Haver, UBS

Figure 14: German and US 10-year yields and QE phases



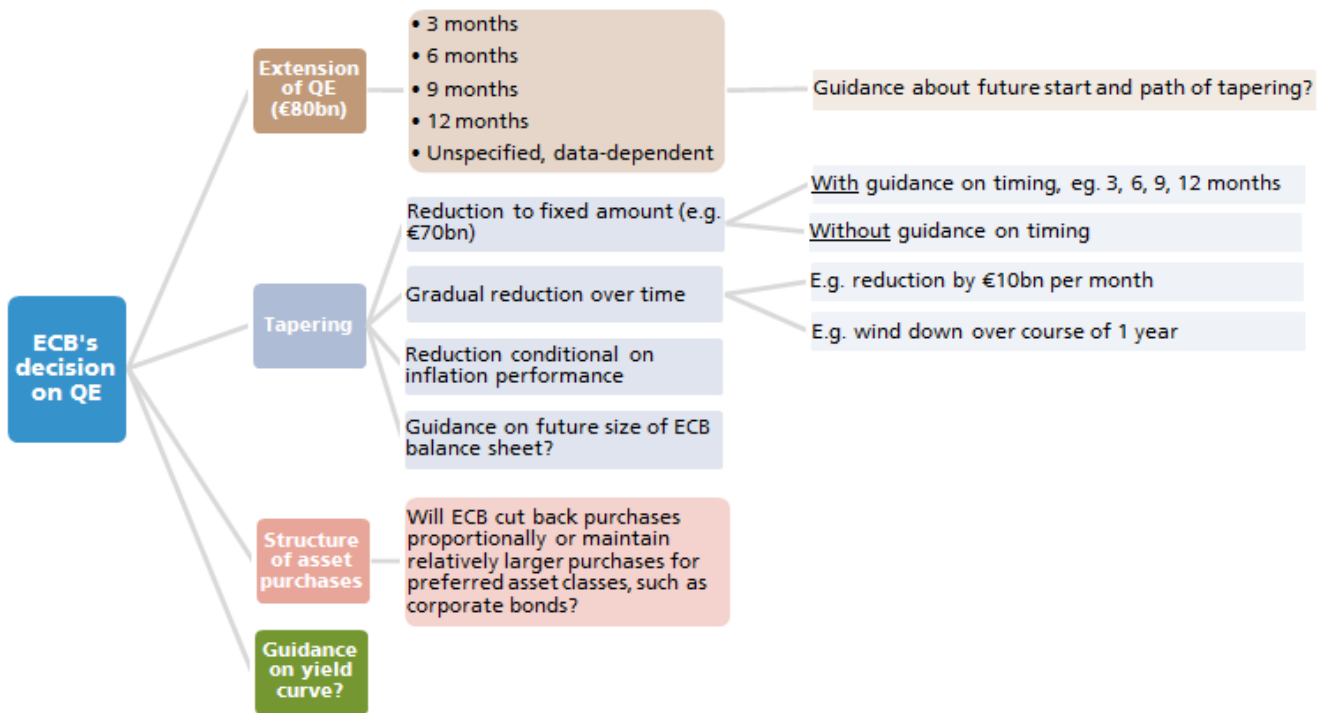
Source: Haver, UBS

Figure 15: German and US 10-year bond yields vs spread



Source: Haver, UBS

Figure 16: The ECB's choices on QE



Source: UBS

Valuation Method and Risk Statement

Risks include macroeconomic variables (such as GDP growth rates and inflation), economic slowdown, a weakening currency, global economic events, and government policy changes.

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